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FM AMEMBASSY NAIROBI
TO RUEHC/SECSTATE WASHDC PRIORITY 7029
INFO RUEHXR/RWANDA COLLECTIVE PRIORITY
RUCPDO/USDOC WASHDC PRIORITY 2905
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS NAIROBI 000468

SIPDIS

DEPT FOR AF/E, AF/RSA
DEPT ALSO PASS TO USTR FOR BILL JACKSON
TREASURY FOR VIRGINIA BRANDON

SIPDIS

E.O. 12958: N/A
TAGS: [ECON](#) [EFIN](#) [EAGR](#) [KE](#)
SUBJECT: KENYA: HIGH INFLATION HITS POOR URBAN RESIDENTS HARDEST

REF: 2006 NAIROBI 4378

11. Summary: Driven mainly by food and fuel prices, overall inflation in Kenya rose sharply in the last quarter of 2006, most heavily impacting poor residents of Nairobi and other urban centers. The Central Bank of Kenya (CBK) expects overall inflation to stabilize in 2007, but similar expectations did not pan out in 2006. Underlying inflation, which excludes food, energy and transportation, remained well below the CBK's 5% target for money supply management. However, the CBK planned to decelerate growth of reserve money and money supply to further dampen underlying inflation pressures and perhaps reduce overall inflation. Based on leading indicators, the CBK raised its 2006 growth forecast from 5.8% to 6%, and predicts similar growth in 2007. Overall, the GOK's macro-economic management in 2006 has been successful, but rising food prices for the urban poor could become a destabilizing socio-political factor in an election year. End summary.

How the GOK Measures Inflation

12. On a monthly basis, the Central Bureau of Statistics (CBS) releases Consumer Price Indices (CPI) and inflation rates for Nairobi and 12 other urban centers, and for lower and upper income groups in Nairobi. The "overall" (headline) inflation rate is based on prices for 10 categories of goods and services. The CBS measures "underlying" (core) inflation by removing the volatile categories of food and energy, but the Central Bank of Kenya (CBK) also removes transportation, since it relies so heavily on energy prices. The CBK uses its underlying rate in its monetary policy planning and implementation.

13. The labels the CBS, CBK, and media use for time series inflation measures are thus misleading and inconsistent. Here are the translations.

Month-on-Month or 12-month: Actually year-on-year (YOY) change in prices, since it compares the CPI in the current month with the CPI in same month in the previous year.

Average Annual: Compares average CPI for the last 12 months with the average CPI of the preceding 12 months. This measure serves as the seasonally-adjusted inflation rate, and is less volatile.

Overall Inflation Measures Peak in December 2006

14. Starting in August, food and fuel price increases accelerated, driving the CPI and overall inflation up. YOY overall inflation rose from 11.5% in August to 15.6% in December. Average annual inflation jumped from 11.4% in August to 14.5% in December. The CBS noted that food prices in December 2006 rose 22.6% YOY, followed by energy prices at 13.5%, alcohol and tobacco at 7%, transportation and communication at 6.5%, and housing at 6%. Prices in the other

five categories rose 2%-5%. The CBK expects overall inflation to stabilize at about 12% in 2007 if the next rainy season is good, international oil prices do not increase, and the shilling continues to strengthen against the dollar. However, the press reports that the main two political parties have lined up Ksh7 billion (about US\$100 million) for this year's general election campaigns. Campaign spending, plus the usual political patronage projects, will increase the inflationary pressures the CBK is trying to contain.

15. The price increases hit low income consumers in Nairobi hardest, since CBS weights food expenditure at 56% of their expenditure. In December, overall inflation for the Nairobi low income group was 19.2% YOY, while middle and upper income group inflation was only 6.4%. In the other urban centers, overall inflation in December was 14.7% YOY. CBS does not yet survey prices in the rural areas, where the majority of the population resides, but staple food prices probably did not rise as much as in Nairobi, since rainy season flood damage to the roads may have boosted local supply by hindering shipments to urban centers.

16. In trying to manage the money supply to control inflation, the CBK continues to face the challenge of a high level of remittances, many through informal channels, from expatriate Kenyans. One source claimed the absence of banking services in South Sudan also caused large dollar inflows, but it was not clear whether these were converted to shillings or used for offshore transactions. The CBK maintained the Central Bank Rate (CBR) at 10% and planned to decelerate growth of reserve money and money supply to dampen underlying inflation pressures. Interest rates remained largely stable in the last quarter of 2006.

Underlying Inflation Falling Slowly

17. The CBK's underlying inflation rate, which excludes food, energy, and transport and communications because of their volatility, fell slightly in December to 4.3% YOY. Average annual underlying inflation (seasonally adjusted) declined steadily in 2006, falling to 3.9% YOY in December. The CBK therefore feels it has inflation largely under control.

CBK Raises Growth Estimate for 2006

18. Based on leading indicators, the CBK raised its 2006 growth forecast from 5.8% to 6%. It attributed the strong growth to macroeconomic stability and improved performance in tourism, telecommunications, energy, construction and manufacturing. The CBK predicted similar growth in 2007. However, instability in Somalia could deter some investment, particularly in the tourism sector on the coast north of Mombasa. AIG Global Investment Group has come in on the low side of prognosticators, predicting just slightly over 5% growth rate in 2007, and cautioning that additional investment is needed to maintain the pace of economic recovery.

19. Kenya's economy, in which agriculture represents over 24% of GDP and the transportation infrastructure is fragile and inadequate, remains vulnerable to weather fluctuations. To reduce inflation and boost economic growth, the GOK needs to invest in infrastructure, especially in repairing the roads that were damaged by the floods of November and December. Investments in water capture would reduce the economic damage caused by both drought and heavy rains.

Comment

110. Overall, the GOK's macro-economic management in 2006 has been successful in maintaining stability and growth. Kenya may achieve 6% growth in 2007, but investors normally hold off investments until after the election results are in. Although politicians have not yet seized on rising food prices for the urban poor as an issue in the general election campaign, it may be hard to ignore a 19% increase over the last year, and it will be difficult for the CBK to keep overall inflation down to 12% in an election year. If the high inflation continues, as seems quite possible, it will make life even harder for 19 million poor Kenyans, and may become another destabilizing factor in Nairobi's already-volatile slums.